



## Sankaty Advisors

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Dear Prospect Harbor Investor,

We are pleased to report that Prospect Harbor generated a return of 5.8% gross and 5.3% net of all fees and expenses in the third quarter. Over the same period, the S&P/LSTA Leveraged Loan, JP Morgan High Yield, and S&P 500 indices returned 3.3%, 6.3% and 11.3%, respectively. With year to date returns of 14.9% gross and 13.4% net, Prospect Harbor has outperformed the S&P/LSTA Leveraged Loan, JP Morgan High Yield, and S&P 500 indices, which returned 6.8%, 11.4%, and 3.9%, respectively, over the same period.

Year to date through the end of October, as previously reported in the monthly snapshot, Prospect Harbor returned 16% net of all fees and expenses, outperforming each of the aforementioned benchmarks.

### **Market Review and Positioning**

High yield credit continued its strong performance in the third quarter. While credit has rallied, we continue to see select opportunities in the new issue market, credit event-driven investments, and anticipate an increasing number of distressed opportunities as we approach the 2012-13 maturity wall.

On balance, spreads remain wide enough to offer attractive absolute and relative returns given the low growth environment we anticipate. At 650 basis points at the end of the third quarter, high yield credit spreads were virtually unchanged for the year. Coupon income and the strong decline in Treasury rates have driven high yield returns thus far this year, which has also accounted for the disparity in performance between loans and bonds.

We have received a number of questions from investors curious about the magnitude of high yield new issue volumes this year. We watch new issue closely as it can be a valuable early warning signal of changes in market direction. We thought it would be helpful to share some of our thoughts, and would note that, at least thus far, the supply in 2010 is not comparable to what we witnessed in 2006 and 2007. Nevertheless, we continue to remain vigilant for new issue "caution signs," such as high leverage levels, weakened covenant packages, sponsor dividend deals, or HoldCo PIK financings.

- *Quantity:* While the high level of new high yield bond issuance has received significant attention, when one takes into account loans and

bonds combined, total issuance is nearly 40% below levels seen in 2006 and 2007.

- *Use of the Proceeds:* Over two thirds of high yield new issuance this year has been to refinance existing debt and to extend maturities. In the overheated markets of 2006/2007 refinancings accounted for just one third of total issuance. A significant portion of 2010's refinancing activity has been bond for loan takeouts, a key theme we profited from in our credit event-driven strategy. While almost half of the proceeds of high yield bond issuance in 2006 and 2007 served to finance acquisitions, only 15% of the proceeds was used for acquisition related finance in 2010.
- *Quality:* New issuance is of higher quality today than in 2006 and 2007. In 2007, 35% of new high yield issuance was CCC, only 10% of which was used for refinancing. In 2010, only 15% of high yield new issuance is CCC, of which 70% has been used for refinancing. Taking into account both debt/EBITDA and interest coverage ratios, overall leverage statistics in 2010 are better than 2007.
- *Pricing:* New issue pricing is attractive, particularly for loans. With an average coupon of Libor plus 450-500 basis points (with a Libor floor of 1.50%-2.00%), today's new issue loan compares favorably to a loan issued in 2006 or 2007 offering a coupon of Libor plus 175-250 (with no Libor floor). Today's loan deals also have full traditional covenant packages.

In today's sluggish economic environment, we believe the opportunity to earn high single digit returns with relative confidence is compelling. Should 1-2% real growth in the US persist for several years to come as we expect, the high current income of loans and bonds coupled with strong downside protection is attractive, particularly when compared to other asset classes. Strong inflows into both loans and bonds suggest that other investors share our sentiments.

Above all, we remain focused on fundamentals. Our view rests on our confidence in our ability to identify the highest quality names out of the approximately 500 issuers in North America and Europe that we track – something that the breadth and depth of our organization has allowed us to do for over a decade. While the new issue market is attractive for the reasons mentioned above, we will invest only in deals with both compelling risk/return and appropriate liquidity for Prospect Harbor. While segments of the new issue market are attractive, the Fund has participated in less than 7% of all new loan and bond deals year to date. Our selectivity has paid off, and these new deals have made solid contributions to returns this year.



The caveat, however, is that the economy cannot worsen significantly. We believe the L-shaped recovery will continue, but we remain concerned. We believe:

- 1) Economic signals are mixed; and, for this late in a recovery, economic expansion is markedly tentative. While green shoots are appearing, blooms are not yet on the horizon.
- 2) Fresh concerns over foreclosure moratoriums are exacerbating uncertainty over a weak housing market.
- 3) Consumer consumption activity differs increasingly between the "haves" and the "have nots."
- 4) While a falling dollar has generated export growth, it has also led to an increase in commodity prices. The dollar's ability to devalue is constrained when most of the developed world still needs to devalue and China is willing to take aggressive measures to protect its currency.
- 5) With an economy that is still highly dependent on fiscal support, the outcome of the midterm elections could lead to gridlock that would have major ramifications for the economy. An expiration of stimulus would be a significant fiscal drag.
- 6) The Fed has demonstrated its commitment to using the tools at its disposal to prevent further deterioration of the economic situation. We expect the Federal Reserve to keep rates low for a very prolonged period.
- 7) It is troubling that further quantitative easing under QE2 is necessary at all, and we are concerned it will not sufficiently address continued weak demand. The current problem is excess leverage (solvency), not liquidity.
- 8) By raising asset prices, QE2 should provide some benefit via the wealth effect. The challenge is that many Americans are still witnessing the depreciation of their largest asset – their home.
- 9) Corporate earnings and cash levels remain solid, and M&A activity is increasing, however this has not flowed through to employment gains, which remains the key to a sustained recovery.
- 10) High grade and high yield corporates are the rare segment of the economy with healthy balance sheets. On the other hand, the balance sheets of small businesses, households, municipalities, states and the Federal Government are still in need of repair.

### Positioning

Given our thoughts on the credit markets and the economy, we are targeting net exposure levels of approximately 80%, which has worked well year to date. We have kept the portfolio diversified across strategies and asset classes, with a good mix of loans and bonds. We expect rates to remain low for the foreseeable future for reasons cited above and believe that spreads have room to tighten. Over the medium term, we anticipate a shift from a larger allocation to bonds to a heavier loan mix to take advantage of an ultimate rise in rates. However, while interest rate movements affect asset classes differently and must be considered when

determining asset class weightings, we believe credit quality remains the critical variable. We continue to enhance the portfolio with special situations, including liquid distressed investments and credit-based equities, and dislocated fixed income assets.

Thematically, our positioning has changed subtly since the end of the second quarter. As a reminder, Prospect Harbor's current investments fall under seven categories: defensive, event driven, relative value, fundamental catalyst, macro/economically sensitive catalyst, stressed/distressed and paired trades. As we noted above, we've seen a high volume of refinancing activity, and nearly 7% of our portfolio (all in our credit event-driven strategy) has been taken out this quarter. We took advantage of positive economic data to reduce our exposure to assets in our macro/economically sensitive catalyst strategy. Lastly, we sold down some of our long assets and covered hedges, reducing our exposure. Please refer to the slide detailing the Fund's positioning at the end of this letter for additional information.

Hedging strategies help us mute the portfolio's volatility and protect against tail risk events. As we have discussed in past letters, we have believed for some time that the tail risks in Europe remain higher than in the US, which led us to add tail risk trades in the European banks and sovereigns earlier this year. We believe Europe's sovereign debt problems are not easily solvable, particularly when coupled with an underlying lack of competitiveness in many of Europe's member countries, an instinct to cut near term spending in an already anemic economy, and the challenges of a union that is monetary but not fiscal. We are also short single names in the US investment grade space that we believe offer potential asymmetric returns, either through their sensitivity to a weaker economic scenario or because they represent interesting potential LBO candidates.

### **Performance Detail**

The performance of our directional credit assets remained strong in the third quarter. We outperformed both the S&P/LSTA Leveraged Loan and JP Morgan High Yield indices year to date with a portfolio comprised of both loans and bonds all while maintaining a shortened duration of 2 years for our directional credit assets—compared to 3.8 years for the JP Morgan High Yield index. When we shortened duration earlier this year, we expected our portfolio to fare differently than an index of high yield bonds would in a falling rate environment, such as the one we have experienced this year. However, should rates increase, our assets will outperform, both given the shorter duration as well as the fact that approximately 43% of our portfolio is in floating rate assets.

In the third quarter, all seven of our investment strategies had ROAs that were markedly positive. Given that defensive and relative value were our largest strategic allocations across the portfolio, it is no surprise that they were also the



strongest contributors, adding 101 and 93 basis points, respectively, to our returns.

Our biggest single name winner for the quarter was Lyondell, where we owned both restructured equity and newly issued bonds. We expected Lyondell to have strong near term performance and had increased our exposure to the name accordingly. Our second biggest winner was Pactiv, which we discuss in more detail in the following paragraph. It is also worth noting that the core portfolio has had few losers. Amongst our long exposure (i.e., excluding hedges) – our largest loser year to date is less than \$1 million.

We continue to find select opportunities in the equities of levered companies (“levered equities”) to enhance the return of our overall portfolio. These investments are in companies we have researched extensively over the years that have high free cash flow yields, debt pay downs, and capital structure opportunities. Our investment in Pactiv, a packing company, serves as a good example of this strategy and our ability to invest across the capital structure. At the time of our investment in Pactiv in January of 2010, we had been following the company for quite some time and recognized that Pactiv was trading well below the industry and historical valuation measures. While not a core part of our initial thesis, we also viewed Pactiv as an attractive LBO candidate due to its very low leverage, stable cash flows, and overall quality. In fact, five months after our initial purchase, rumors of a potential LBO or acquisition of Pactiv surfaced, with Berry, Reynolds Group, and Georgia Pacific named as suitors. Our existing knowledge of these companies allowed us to evaluate quickly the potential synergies from a combination, and we added to our existing holdings at a level that, while above the previous purchase price, was still well below the price where a transaction was likely to occur. We were able to express our investment thesis in our debt portfolio as well, and we bought Georgia Pacific bonds on the prediction that the company was unlikely to buy Pactiv. Events played out as we had anticipated, and we recently sold the bonds at a price of 114 following a further upgrade to investment grade. Lastly, we participated in the new issue for Reynolds Group, the eventual buyer of Pactiv. Both the Reynolds’ loans and bonds are trading above par.

We believe, as always, that the key to success in investing is diligence and patience. We continue to focus on our core competency - identifying good relative value in credit regardless of the macro environment. We seek to achieve attractive returns without prognosticating on the direction of interest rates, staying focused on event-driven opportunities, and by refusing to take on excessive risk by reaching for yield in over-levered LBOs in an uncertain environment.

### **Designated Investments**

In the third quarter, designated investments returned 8.2% gross/7.8% net. The table below provides a detailed attribution of these assets’ performance. Year to

date, the original \$403.1 million designated bucket has earned 21.9% (\$83.1 million) profits. 23.6% (\$95.1 million) of the original \$403.1 million designated bucket has been harvested, and we are optimistic that this pace will continue through the rest of the year and into 2011.

2010 Q3 Designated Returns		
	Return on Assets	Contribution to Return
Loans and Bonds	4.6%	1.7%
Equity	14.5%	1.5%
Mezzanine	8.7%	1.0%
Structured	31.0%	3.4%
		7.6%
	Interest, Fees and FX	0.2%
	<b>NET DESIGNATED FUND RETURN</b>	<b>7.8%</b>

### Closing

In an effort to continue to provide better service to our partners, we are pleased to welcome two new senior professionals to our Investor Relations team, Dorothy Crocker ([dcrocker@sankaty.com](mailto:dcrocker@sankaty.com)) and Tom Sargeant ([tsargeant@sankaty.com](mailto:tsargeant@sankaty.com)). Dorothy will be based in our New York City office while Tom joins the Sankaty team in London, which will enable us to provide more timely service to our European and International investors.

As you recall, the Fund is now open once again to capital additions under new terms. If you are interested in adding additional capital or have any other questions regarding the Fund, please contact us.

Sincerely,

Sankaty Advisors



	Net Returns						
	Q1	Q2	JUL	AUG	SEP	Q3	YTD
CORE	5.7%	-0.2%	1.2%	1.3%	1.6%	4.1%	9.9%
DESIGNATED	10.5%	2.4%	1.5%	2.3%	3.8%	7.8%	21.9%
TOTAL FUND	7.1%	0.6%	1.3%	1.6%	2.3%	5.3%	13.4%
LSTA	4.6%	-1.2%	1.5%	0.3%	1.4%	3.3%	6.8%
JPM HY	4.7%	0.1%	3.3%	0.1%	2.8%	6.3%	11.4%
S&P 500	5.4%	-11.4%	7.0%	-4.5%	8.9%	11.3%	3.9%

	Core Exposure by Asset Class			Contribution to Return
	Long % of NAV	Short % of NAV	Net % of NAV	
Secured Bank Loans and LCDs	46.3%	-0.3%	46.0%	2.1%
High Yield Bonds and CDS	79.1%	-11.7%	67.4%	2.4%
Equity	9.1%	-6.2%	2.9%	0.0%
Investment Grade Securities	54.0%	-87.8%	-33.8%	-0.4%
Other	11.3%	0.0%	11.3%	0.3%
<b>TOTAL</b>	<b>199.8%</b>	<b>-106.0%</b>	<b>93.8%</b>	<b>4.4%</b>
Less Interest, FX and Fees				-0.3%
<b>NET CORE RETURN</b>				<b>4.1%</b>

	Core Exposure by Strategy			Net % of NAV	Contribution to Return
	Long % of NAV	Short % of NAV			
<b>Directional Credit</b>					4.5%
Defensive	28.7%	0.0%		28.7%	
Event Driven Catalyst	17.6%	0.0%		17.6%	
Fundamental Catalyst	13.5%	0.0%		13.4%	
Relative Value	40.3%	-29.3%		11.0%	
Macro Catalyst	10.6%	0.0%		10.6%	
<b>Stressed/Distressed Credit</b>					0.4%
Paired Trades	5.9%	0.0%		5.9%	
	73.6%	-70.5%		3.1%	-0.3%
Equities	9.6%	-6.2%		3.4%	-0.2%
<b>TOTAL</b>	<b>199.8%</b>	<b>-106.0%</b>		<b>93.8%</b>	<b>4.4%</b>
	Less Interest, FX and Fees				-0.3%
	<b>NET CORE RETURN</b>				<b>4.1%</b>

	Fund Net Equity (\$m)		
	6/30/2010	Profits	Contributions/ (Distributions)
TOTAL FUND	1,261.4	67.1	(85.4)
			9/30/2010
			1,243.1

Top Ten Long Core Exposures		% of NAV
Swift Transportation Co. Inc.		2.9%
Aeroflex		2.4%
Hertz Corp		2.3%
Kabel Deutschland		2.3%
Outback Steak House		2.3%
Chaparral Energy Inc		2.2%
Graham Pack		2.1%
Pinnacle Foods Finance LLC		2.1%
Rexnord		2.0%
Alere, Inc.		2.0%
<b>Top 10 Long Exposures</b>		<b>22.6%</b>

Top Five Core Industry Exposures	
	Net % of NAV
Industrial Products	11.9%
Consumer Defensive	10.9%
Basic Materials	10.5%
Cable and Wireless	8.6%
Healthcare	8.5%

Core Asset Geographical Exposure	
	Net % of NAV
North America	82.0%
Europe	9.1%
Other	2.7%
<b>Total</b>	<b>93.8%</b>

Return on Core Assets	
Long Credit*	5.3%
Short Credit*	-1.3%
Equities	7.3%

All Prospect Harbor performance estimates provided herein are with respect to the "core" fund, excluding designated investments, unless noted otherwise.

Portfolio returns are computed based on the change in value during the period of a theoretical investment made at the beginning of the period. In value of a theoretical investment is measured by comparing the aggregate ending value of Limited Partners with the aggregate beginning value adjusted for cash flows received from contributions or withdrawal of capital during the period. Returns are geometrically compounded on a monthly basis. The return on the investment is calculated as the ratio of the ending value of the portfolio divided by the beginning value of the portfolio. The return on the investment is calculated as the ratio of the ending value of the portfolio divided by the beginning value of the portfolio.

Single name CDS/LCDS, Index CDS/LCDS, Tranche CDS/LCDS, Structured CDS and Structured Revolvers are included at notional value plus mark to market, indicative of the long or short market risk related to these exposures.

There can be no assurance that the results achieved by Sankaty will be achieved by other investments. Past performance should not be relied upon as an indication of future results.

\* The long and short credit books consist of directional, stressed, and distressed credit, excluding the corresponding legs of the paired trades. A positive ROA on short credit indicates a positive contribution to return.